Bank of Japan's August report of recent economic and financial developments[1]

Bank of Japan, Communication, 17 August 1999.

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The Bank's view[2]

Japan's economy, at present, has stopped deteriorating, and corporate sentiment has seen a slight improvement recently. However, clear signs of a self-sustained recovery in private demand have not been observed yet.

With regard to final demand, business fixed investment has been on a downward trend. Recovery in private consumption continues to be weak on the whole. Net exports (exports minus imports) are sluggish at present due to an increase in imports. Meanwhile, housing investment has continued to recover, and public works have been rising.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production has stopped decreasing. In addition, corporate and consumer sentiment has seen an improvement due to the effects of measures taken to restore the stability of Japan's financial system and the continued monetary easing by the Bank. The improvement in corporate sentiment, however, has not necessarily stimulated business activities, because firms strongly feel that they have excess capacity and employees and their profits remain weak. Meanwhile, the improvement in consumer sentiment is underpinning household expenditure even under the worsening employment and income conditions, but is not strong enough to push up overall private consumption.

As for the outlook, with the progress in inventory adjustment gradually paving the way for a recovery in production, improvements in the overall financial environment partly due to the monetary easing by the Bank, along with a series of economic measures taken by the government, are expected to continue underpinning the economy. Moreover, the recovery of overseas economies, especially of Asian economies, is likely to have a positive impact on domestic production. Nevertheless, under cautious sales plans, firms are implementing further restructuring to improve their profitability. Although such corporate restructuring is expected to improve productivity, it is likely, in the short run, to reduce fixed investment and discourage household expenditure through the resulting deterioration in employment and income conditions. Under such circumstances, it is still difficult to expect an immediate self-sustained recovery in private demand. Overall economic developments require careful monitoring in consideration of the above points. It is also important to promote structural reform in order to assure the economy's sustained growth in the medium term.

With regard to prices, import prices continue to rise due to the increase in international commodity prices such as crude oil prices. Domestic wholesale prices are leveling off due to the progress in inventory adjustment as well as an increase in prices of some products closely related to international commodities, such as those of petroleum products. Consumer prices are also leveling out. On the other hand, corporate service prices continue to decline. For a while, movements of overall prices are likely to be flat, as import prices are rising and the decline in domestic commodity prices has come to a halt reflecting the progress in inventory adjustment. However, distinct narrowing in the output gap is

[1] This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on August 13, 1999.

[2] The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on August 13 as the basis of monetary policy decisions.

unlikely for the time being even though the economy has stopped deteriorating, and wages continue to decline. Thus, downward pressure on prices is expected to remain.

In the financial market, the overnight call rate has stayed at nearly zero, and financial institutions have been confident about the availability of overnight funds. Interest rates on term instruments slightly increased from the middle of June but then fell back, and have recently been steady. However, those on instruments maturing beyond the year-end are relatively high partly due to market participants' concern over the Year 2000 problem.

The Japan premium has continued to be nearly zero.

Yields on long-term government bonds fell to the level of 1.6 percent in the middle of July, but have slightly increased to 1.8-1.9 percent. The yield spread between government bonds and private bonds, especially corporate bonds with relatively low credit ratings, has narrowed further.

Stock prices fell in late July against the background of the appreciation of the yen and the recent weak tone in U.S. stock prices. The current level is around 17,000-17,500 yen.

The amount outstanding of funds in the call money market has remained generally stable since the middle of June. To date, this has not led to any difficulty in funds settlement, but close attention should be paid to future market developments.

With regard to corporate finance, private banks have basically retained their cautious lending attitude. However, constraint that had been caused by severe fund-raising conditions and insufficient capital base has eased considerably. Under these circumstances, major banks have gradually become more active than before in extending loans, while carefully evaluating the credit risks involved.

However, credit demand for economic activities such as business fixed investment remains weak. In addition, firms' moves to increase their on-hand liquidity have settled down. As a result, credit demand in the private sector has continued to be weak, and thus private banks' lending has remained sluggish. Furthermore, the pace of issuance of corporate bonds and CP has generally been slowing.

Money stock (M_2+CDs) has recently shown a year-to-year increase of over 4 percent partly due to an increase in fiscal expenditure.

In this financial environment, credit conditions have eased somewhat.

The following continue to warrant careful monitoring: how actively investors will take risks; how far private banks will ease their lending stance; and how these changes will affect economic activities.